

*Planning for Asset Protection of Inherited IRAs after the U.S. Supreme Court's  
decision in Clark v Rameker, 134 S.Ct. 2242 (2014)*

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The United States Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“the Act”), signed into law by President G.W. Bush, drastically altered the debtor/creditor landscape. It also explicitly extended the bankruptcy protection afforded to qualified retirement plans (401k, 403b) to Individual Retirement Accounts (“IRAs”) up to \$1 million, inflation adjusted. (Bankruptcy Code Section 522 (b)). Left to be determined by the changes wrought by the Act was the exemption status of “inherited IRAs,” which are either traditional or Roth IRAs held by inheritors following the death of the IRA owner. There are two categories of IRA inheritors, or beneficiaries, each with distinct inherited IRA tax and distribution requirements- (1) the surviving spouse, and (2) any other beneficiary, including, but not limited to children, grandchildren, estates, and trusts.

On June 12, 2014, the Supreme Court, in *Clark v. Rameker*, 134 S.Ct. 2242 (2014), ruled in a case from the Bankruptcy Court for the Western District of Wisconsin that despite the Act’s exemption of traditional IRAs up to \$1 million, inherited IRAs enjoy no special protection in bankruptcy, and are not exempt from creditor claims in a bankruptcy proceeding under federal law, as the funds they hold do not constitute “retirement funds” within the meaning of the Act. With Americans keeping an estimated \$5.4 trillion of assets in IRAs, this decision has far reaching effects on the owners of IRAs. Many who have inherited these retirement benefits hold them in an inherited IRA form to stretch out the required distributions over their life expectancies. This structure is now subject to creditor claims in the event of the beneficiary’s bankruptcy, and also in non bankruptcy state law proceedings, depending on the residence of the beneficiary and that jurisdiction’s particular exemptions.

Instrumental to the Supreme Court’s decision in *Clark* was the interpretation of the federal bankruptcy exemption of “retirement funds”, with the Court drawing the distinction between inherited IRAs and traditional or Roth IRAs. The Court reasoned that, unlike a regular IRA owner, beneficiaries of an inherited IRA (1) cannot add money to the account, (2) must take out annual distributions under a life expectancy calculation or a fixed five year method (see Internal Revenue Code sections 72(q) (1) and 401(a) (9) (B)), and (3) have the ability to withdraw the totality of the funds at any time without being subject to the early withdrawal penalty. The Court found that these characteristics of an inherited IRA cause it to be more of a ‘pot of money’ rather than a retirement fund, and therefore held the inherited IRA not to be exempt from creditors.

Spousal beneficiaries are entitled to “roll over” or transfer their share of an inherited IRA into their own spousal IRA account. Once rolled over, the funds would not be subject to the claims of spousal creditors under bankruptcy law, based on the rationale utilized by the Supreme Court in *Clark*. With a spousal IRA, the spouse can make contributions to the spousal IRA, the spouse must take minimum distributions exactly in the same manner as would be true for that particular type of plan, and the 10% early withdrawal penalty applies to the funds rolled over in the event that the spouse withdraws funds before 59½.

Generally, if the ability to make penalty free withdrawals for a 59 ½ or younger spouse out of an inherited IRA are trumped by asset protection concerns, this spousal rollover should be performed as soon as practicable in order to obtain the asset protection of the spousal IRA.

For non-spousal beneficiaries holding inherited IRA's, the states in which they reside have the power to opt out of the federal exemptions listed in section 522(d) of the Bankruptcy Code and either mandate that a debtor select the state exemptions, or allow him to choose between state and federal exemptions. Several states have expressly exempted inherited IRAs from bankruptcy proceedings, although inherited IRA's may still be subject to creditors in non-bankruptcy state court proceedings in those states.

Illinois requires bankruptcy debtors with IRAs to use state law exemptions covering "retirement plans, including an individual retirement annuity or account" 735 ILCS 5/12-1006(a). Although this wording differs from the wording under the Act, the United States Bankruptcy Court for the Northern District of Illinois has denied a motion arguing that the plain language of the applicable Illinois exemption is broader than that of the federal exemption circumscribed by the Supreme Court in *Clark*. (*In re Taylor*, No. 12-16471 (Bankr. N.D. Ill.).

Owners of IRAs wishing to plan for protection of the beneficiaries of their IRAs from creditors can create a so called "see through" inter vivos or testamentary trust as the IRA's beneficiary, pursuant to Regulations Section 1.401 (a)(9)-4. If valid under state law, irrevocable at death, individual beneficiaries are identifiable from the trust instrument, and certain provisions are present prohibiting the assignment or transfer of the beneficiaries' interests, such a trust can act to shield inherited IRA funds from creditors, and the beneficiaries of the trust will be treated as the beneficiaries of the IRA. If the trust beneficiaries are treated as beneficiaries of the IRA, the trust may be able to stretch IRA distributions out over the oldest beneficiary's life expectancy. Certain documentation must also be timely provided to the custodian or plan administrator. Such a trust can be designed as a fully discretionary trust, thereby providing the maximum protection from creditors.

The Supreme Court's decision in *Clark v. Rameker* should provide a special impetus to planning for asset protection where significant estate wealth is concentrated in IRAs.

UPDATE 10/16/14: The United States Bankruptcy Court for the Northern District of Illinois has rejected the debtor's claim in *In re Taylor*, No. 12-16471, that Illinois' inherited IRA bankruptcy exemption from creditors is broader than the federal exemption. The judge, however, provided no reasoning for his decision. Thus the issue of whether inherited IRAs are exempt from creditor collections in a bankruptcy proceeding in Illinois remains undecided until a higher court issues a ruling.

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